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The Honorable Jerome Powell

Chairman

Federal Reserve Board of Governors

Constitution Ave. and 20th St. NW

Washington, DC 20551

Dear Chairman Powell:

I write to request clarification on a series of questions I asked you during your appearance before the House Financial Services Committee on February 27th. I am also following-up on another question, which you stated you would answer after the hearing, and for which I have not yet received a response.

1. I asked: "Is the Fed not reducing loss-absorbing capital requirements for big banks?" You responded: "No, we're not."

In April of last year, the Board of Governors of the Federal Reserve (Fed), along with the Office of the Comptroller of the Currency (OCC), announced its proposal¹ to reduce the leverage limitation for the eight largest banks from six percent to three percent plus one half of the Globally Systemically Important Banks (G-SIBs) surcharge. This change would immediately lower the capital levels at the taxpayer-backed insured depository institution (IDI) subsidiaries by 20%—a cumulative 21 billion.² Large banks are likely to transfer this \$121 billion from their IDIs to their bank holding companies (BHCs), which will then distribute those funds out of the

¹ "Federal Reserve Board seeks comment on proposal to simplify its capital rules for large banks while preserving strong capital levels that would maintain their ability to lend under stressful conditions," *Board of Governors of the Federal Reserve System Press Release* (April 2018) at: <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180410a.htm>

² The Editorial Board, "The Fed's Capital Mistake: Regulators give in to the bank lobby's wish for more leverage," *Wall Street Journal* (April 2018) at: <https://www.wsj.com/articles/the-feds-capital-mistake-1524180265>

holding company to shareholders through dividends and stock buybacks.³ This will have the effect of reducing the capital standing behind IDIs, whose liabilities are insured by the federal government through the Deposit Insurance Fund (DIF). In fact, the total proposed capital reductions noted above are nearly 30% larger than the total value of the DIF, which as of March 31, 2018, had assets just over \$95 billion.⁴ The proposal would also reduce the Bank Holding Company (BHC) Enhanced Supplementary Leverage Ratio (eSLR) from five percent to three percent plus one half the G-SIB surcharge.

These are reductions in capital holding requirements in the most literal sense. Therefore, your answer to Committee was disingenuous at best.

Some policymakers, including yourself, have reasoned that system-wide capital will not be reduced as precipitously as these numbers suggest because risk-based capital measures and stress testing regimes will remain in place and will interact with eSLR reductions to mitigate system-wide decreases in capital.⁵ However, history has demonstrated that banks, over time, will game risk-based capital models in an effort to “optimize” capital requirements.⁶ Indeed, at the BHC level, the aggregate decline in required eSLR capital would amount to \$86 billion if the proposed rulemaking is adopted.⁷ I believe that this is a more appropriate representation of the likely capital reductions at the impacted GSIBs over the long-term, when accounting for future financial engineering. Soon after the Fed’s April announcement, the Editorial Board of the *Wall Street Journal* called the decision “short-sighted” and published a piece entitled: “The Fed’s Capital Mistake: Regulators give in to the bank lobby’s wish for more leverage.”⁸ I believe the Editorial Board’s analysis is correct.

In October of last year, the Fed approved a draft proposal the *Wall Street Journal* referred to as: “one of the most significant rollbacks of bank rules since President Trump took office with a proposal for looser capital and liquidity requirements for large U.S. lenders.”⁹ The proposal would substantially reduce liquidity requirements for banks with between \$100 billion and \$700 billion in assets (a reduction of between roughly 15 and 30%). Banks with between \$250 billion and \$700 billion in assets would also be allowed to opt-out of the Accumulated Other

³ Bair, Sheila and Thomas Hoenig. “Relaxing Bank Capital Requirements Would Risk Another Crisis.” *Wall Street Journal*, April 26, 2018. Available at: <https://www.wsj.com/articles/relaxing-bank-capital-requirements-would-risk-another-crisis-1524784371>

⁴ Federal Deposit Insurance Corporation. “Quarterly Banking Profile for the First Quarter of 2018.” Available at: <https://www.fdic.gov/bank/analytical/qbp/2018mar/qbp.pdf>

⁵ Quarles, Randal. “Liquidity Regulation and the Size of the Fed’s Balance Sheet.” Speech at ‘Currencies, Capital, and Central Bank Balances: A Policy Conference’ at the Hoover Institution Monetary Policy Conference, Stanford University, Stanford, CA. May 4, 2018. Available at: <https://www.federalreserve.gov/newsevents/speech/quarles20180504a.htm>

⁶ See supra, note 35

⁷ Eavis, Peter. “Washington Wants to Weaken Bank Capital Rules. Not Every Regulator Agrees.” *New York Times*, April 24, 2018. Available at: <https://www.nytimes.com/2018/04/24/business/dealbook/bank-rules-leverage-ratio.html?rref=collection%2Fbyline%2Fpeter-eavis>

⁸ The Editorial Board, “The Fed’s Capital Mistake: Regulators give in to the bank lobby’s wish for more leverage,” *Wall Street Journal* (April 2018) at: <https://www.wsj.com/articles/the-feds-capital-mistake-1524180265>

⁹ Ryan Tracy, “Fed Proposes Looser Rules for Large U.S. Banks: Proposal marks one of the most significant rollbacks of bank regulations since Trump took office,” *Wall Street Journal* (October 2018) at: <https://www.wsj.com/articles/fed-set-to-propose-looser-rules-for-large-u-s-banks-1540995057>

Comprehensive Income (AOCI) capital requirement. The AOCI capital requirement forces banks to reflect the mark-to-market losses on some of their securities holdings in their capital levels. For this reason, Governor Lael Brainard voted against the proposal, noting that it would “weaken the buffers that are core to the resilience of our system.” Governor Brainard added that, “this raises the risk that American taxpayers again will be on the hook. The proposed reduction in core resiliency comes at a time when large banks have comfortably achieved the required buffers and are providing ample credit to the economy and enjoying robust profitability.” A dissenting vote from a Federal Reserve Governor is rare; indeed, during Chair Yellen’s tenure there was unanimity on every vote of the Board. This dissent should give the Board pause and cause you to rethink the reversal in post-crisis era taxpayer protections.

2. I asked: “With regard to stress testing, which is one of the ways that we assess risk, my understanding is that the Fed has recently advanced proposals to reduce the stress testing standards.” You responded: “No I wouldn’t say that’s right, no.”

Last April, the Fed proposed changes to several assumptions used in supervisory stress tests that generally relax requirements versus those currently used. That proposal would: 1) require banks to plan for four quarters of dividends, rather than the current nine quarters of both dividends *and* stock buybacks, 2) require a bank to maintain a constant level of assets, rather than a growing balance sheet as required in current stress tests, and 3) eliminate heightened capital distribution plan scrutiny by the Fed of banks that have dividend payout ratios of more than 30%.¹⁰ In October, the Fed also changed the frequency of previously-annual stress tests for banks with between \$100 and \$250 billion in assets to once every two years.¹¹

Last November, the Fed proposed removing the stressed SLR binding constraint in its Stress Capital Buffer (SCB) proposed rulemaking and suggested replacing it with a less stringent stressed Tier 1 leverage requirement.¹² This shift to the Tier 1 leverage ratio would have the impact of excluding off-balance sheet exposures—exposures which during the last crisis came onto the balance sheets of large banks when they experienced stress.¹³ Three banks: Morgan Stanley, Goldman Sachs and State Street, failed to maintain at least one minimum post-stress capital ratio under the Fed’s severely adverse scenario under the Comprehensive Capital Analysis and Review (CCAR). But those banks achieved grades of “conditional non-objection”

¹⁰ “Federal Reserve Board seeks comment on proposal to simplify its capital rules for large banks while preserving strong capital levels that would maintain their ability to lend under stressful conditions,” *Board of Governors of the Federal Reserve System Press Release* (April 2018) at:

<https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180410a.htm>

¹¹ “Federal Reserve Board invites public comment on framework that would more closely match regulations for large banking organizations with their risk profiles,” *Board of Governors of the Federal Reserve System Press Release* (April 2018) at: <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181031a.htm>

¹² Board of Governors of the Federal Reserve System. “Federal Reserve Board Seeks Comment on Proposal to Simplify its Capital Rules for Large Banks While Preserving Strong Capital Levels that Would Maintain Their Ability to Lend Under Stressful Conditions.” *Press Release*, April 10, 2018. Available at:

<https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180410a.htm>

¹³ See FCIC, *supra*, note 7 (specifically the example of Citigroup’s SIVs during the crisis)

and were permitted to proceed with prior year capital distributions anyway.¹⁴ A move to a Tier 1 leverage ratio in future years would weaken an already too lax CCAR process and would likely allow those banks to engage in even further distributions that would deplete loss-absorbing capital. While I do not know how regulators anticipate the SCB and eSLR proposed rulemakings interacting, one research note from Goldman Sachs estimates that total distributable capital across GSIBs will increase by \$54 billion, meaning fewer resources to guard taxpayers against bailouts.¹⁵

In early February, the Fed finalized changes that make stress tests more “transparent” (read: giving banks the answers before they take the tests),¹⁶ and exempted certain banks from the 2019 stress tests while the Fed works to finalize the permanent reduction in stress testing frequency for these banks.¹⁷ Last November, Vice Chair for Supervision Randal Quarles suggested the Fed may go even further and remove leverage measures from the stress tests entirely.^{18 19}

Not to be outdone, in March of this year, the Fed announced that it would eliminate the qualitative portion of bank stress tests for the largest banks.²⁰ The change abolishes the Fed’s ability to offer an objection to a bank’s capital plan on the basis of the qualitative portion of stress tests, which measure a bank’s ability to manage risks. Without failing grades, the public has no way of knowing whether a bank has appropriate governance, risk management, and internal controls, i.e. is run in a safe and sound manner that will guard taxpayers from the risk of a collapse like those we saw in 2008. Note that since the Fed began the CCAR process, banks such as Deutsche Bank, Santander, Citigroup, HSBC, RBS Citizens, Ally Financial and BB&T have all received objections to their capital plans on the basis of qualitative failures.

These are reductions in stress test standards. Again, your answer to Committee was disingenuous at best.

¹⁴ Board of Governors of the Federal Reserve System. “Comprehensive Capital Analysis and Review 2018: Assessment Framework and Results.” July 2018. Available at:

<https://www.federalreserve.gov/publications/files/2018-ccar-assessment-framework-results-20180628.pdf> (page 11)

¹⁵ Goldman Sachs Equity Research. “Americas Banks: SLR/TLAC Proposal: Shifting Binding Constraints Gives Boards Greater Control Over Whether to Reinvest or Distribute.” April 12, 2018.

¹⁶ “Federal Reserve Board finalizes set of changes that will increase the transparency of its stress testing program for nation’s largest and most complex banks,” *Board of Governors of the Federal Reserve System Press Release* (February 2019) at: <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190205a.htm>

¹⁷ “Federal Reserve Board releases scenarios for 2019 Comprehensive Capital Analysis and Review (CCAR) and Dodd-Frank Act stress test exercises,” *Board of Governors of the Federal Reserve System Press Release* (February 2019) at: <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190205b.htm>

¹⁸ “A New Chapter in Stress Testing, Vice Chairman for Supervision Randal K. Quarles at the Brookings Institution,” *Board of Governors of the Federal Reserve System Press Release* (November 2018) at: <https://www.federalreserve.gov/newsevents/speech/quarles20181109a.htm>

¹⁹ Lalita Clozel, “Fed to Further Overhaul Stress-Testing Regime, Making it Easier for Banks to Pass: Regulator aims to make test scenarios more consistent from year to year, Quarles says,” *Wall Street Journal* (November 2018) at: <https://www.wsj.com/articles/fed-to-further-overhaul-stress-testing-regime-making-it-easier-for-banks-to-pass-1541774507>

²⁰ “Federal Reserve Board announces it will limit the use of the ‘qualitative objection’ in its Comprehensive Capital Analysis and Review (CCAR) exercise, effective for the 2019 cycle,” *Board of Governors of the Federal Reserve System* (March 2019) at: <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190306b.htm>

The combined effect of the Fed's changes will increase systemic risk and endanger both bank investors and the taxpaying public. As stated by a Fitch Ratings analyst, "taken together, these regulatory announcements raising the bar for systemic risk designation and relaxed standard for qualitative objection on the CCAR stress test reinforce our view that the regulatory environment is easing, which is a negative for bank creditors."²¹

3. I asked (in reference to the Financial Stability Oversight Counsel (FSOC)'s hedge fund working group): "Can you describe whether this working group is actually in fact doing any work, and the nature of that work, and when we can expect to see any work product? It's been a little over two years since we've had any information from that working group, and I would like to see its results and what it's doing."

Please explain under which factual circumstances the responses you delivered to the Committee on February 27th to the first two questions might be viewed as truthful, given detailed and prolific evidence to the contrary. While I appreciate your willingness to take a firm position and give a short answer "no," the public and my colleagues in Congress could believe from your sworn testimony that the Fed's actions are contrary to the facts. Please also provide a detailed summary of the work completed so far by FSOC's hedge fund working group.

Sincerely,



Congresswoman Katie Porter

²¹Mayra Rodriguez Valladares, "U.S. Bank Regulatory Easing Is Negative For Investors And Taxpayers," *Forbes* (March 2019) at: <https://www.forbes.com/sites/mayrarodriguezvalladares/2019/03/07/u-s-bank-regulatory-easing-is-negative-for-investors-and-taxpayers/#712ed5cc9a8e>